# THE GROWTH GAME: US UNEMPLOYMENT AND FEDERAL RESERVE POLICIES

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## CONFIDENCE BUILDING: ART AND ARTIFICE

A dialogue from the movie, “Being There” (1979; Hal Ashby, director):

*US President “Bobby”: “Mr. Gardner…do you think that we can stimulate growth through temporary incentives?”
*Chance the Gardener [a well-meaning yet rather simple-minded and uneducated fellow who nevertheless gains a respected position in elevated Washington circles]: “As long as the roots are not severed, all is well. And all will be well in the garden…In the garden, growth has its seasons. First comes spring and summer, but then we have fall and winter. And then we get spring and summer again.”
*Benjamin Rand: “I think what our insightful young friend is saying is that we welcome the inevitable seasons of nature, but we’re upset by the seasons of our economy.”

A proclamation by Federal Reserve Chairman Ben Bernanke following various monetary easing measures and shortly after early March’s 2009 stock marketplace bottom: “And I think as those green shoots begin to appear in different markets and as some confidence begins to come back that will begin the positive dynamic that brings our economy back….I do see green shoots.” (60 Minutes, CBS, 3/15/09).

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In response to the dreadful domestic and international economic crisis, America’s politicians and central bank have adopted gigantic deficit spending, massive money printing, and low interest rates as incentives to restore and sustain economic growth. Numerous other nations diligently have embraced similar methods. Witness European Central Bank, Chinese, Japanese, British, and Swiss measures. Many of these policies have persisted long enough so that they seem much more than temporary. Despite occasional outbursts of sunny optimism, the vigorous continuation of such strategies reflects the ongoing gloomy worldwide economic crisis. Even if much business confidence seems fairly healthy, consumer confidence (use the US as a yardstick) remains mediocre. On the currency field, many countries yearn for their currency to be relatively feeble, or at least not overly strong. The US dollar, though it has climbed from its summer 2011 trough, remains relatively weak from a long run perspective.

## UNEMPLOYMENT AND FED POLICIES: SOME ISSUES

Distressing US unemployment measures (and of course some other variables) promote Fed fears. Thus that guardian “expects to maintain a highly accommodative stance for monetary policy”. This guru “currently anticipates that economic conditions- including low rates of resource utilization and a subdued outlook for inflation over the medium run- are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.” (FOMC Press Release, 8/1/12).

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Chairman Bernanke often speaks of the Fed’s dual mandate of “maximum employment and price stability”. (See his Jackson Hole, Wyoming speech, “Monetary Policy since the Onset of the Crisis”, 8/31/12).

Yet the Fed seldom points out that its legislated goals include a specific interest rate reference. The Fed must "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." (See the Federal Reserve Act, Section 2A. Monetary Policy Objectives).

What's the situation on the US price horizon? The Congressional Budget Office weathervane forecasts year-on-year changes in inflation for 2012 and thereafter. For 2012, the personal consumption expenditures index (broad PCE; not the core, which excludes food and energy) heads 1.7 percent higher. In 2013, the PCE stretches up 1.3pc, with 2014-17 rising 1.8pc per year. The CBO estimates for the consumer price index climb slightly more than this PCE rate. ("An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022", August 2012, Table 2.1, p33).

Of course the Fed faces challenges in interpreting and applying its mandate. These goals may sometimes be in tension, difficult to balance. And its opinions as to moderate interest rates indeed may extend beyond those of the US Treasury yield curve. Government debt obligations are not the only ones; think of mortgages, consumer lending, and so on.

Nevertheless, compare the first several years of the US Treasury yield curve relative to current and forecast inflation statistics from the CBO. Real returns look negative. The two year UST note is about .25pc, with the five year UST .65pc (under one percent). So although US inflation has been low, the Fed's yield repression interest rate policy (whatever its merits), which probably will extend at least through end 2014, tends to cheat savers in UST (and assist the US government debtor- "We, the people", in a representative government). Lower interest rates for the UST benchmark help to slash yields for (lower real costs for) and thus benefit other debtors/borrowers (state, local, corporate, household). Creditors/lenders correspondingly suffer via reduced real return relative to inflation. Admittedly, marketplace gardeners can argue that the Fed's current interest rate agenda benefits "all of us" over the long run.

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Scan US 10 year Treasury yields from nowadays back to 1925 (Fed H.15 statistics; the January 1925-March 1953 period is a composite yield on bonds with a maturity over ten years). UST note yields have withered, slipping to a record daily low of 1.43 percent on 7/25/12. The July 2012 monthly average at 1.53pc likewise achieved an all-time depth (August 2012 was 1.68pc). This July 2012 average yield decisively broke under the decades-old record, October 1941's 1.98pc. The recent UST 10 year yields slump beneath December 2008's 2.42pc. Compare the monthly averages for the UST yield low in June 2003 (3.33pc). They even fall beneath depths attained during the Great Depression (2.54pc in February 1937 and 3.13pc in June 1931).

Other supply/demand factors in addition to Federal Reserve actions (including its wordplay) influence the UST yield curve level, shape, and trend. Inflation is rather low nowadays. Despite some statistics suggesting economic growth (GDP increases, the stock marketplace rally), such low UST rates arguably partly reflect a feeble economy (look at consumer confidence). The international economic situation does too; picture fearful "flights to quality" into UST. In any event, Fed policy remains crucial for government yields. Since the Federal Funds target (and the first few years of the yield curve) reside under current (and recent past as well as forecast) American inflation levels, Fed policy deserves substantial credit for depressing 10 year and other government rates. Another factor underscores the major role of the benevolent Fed. The United States fiscal situation of course matters greatly for interest rates. Since this variable (high demand

for credit) in recent years (and arguably for the future) probably points to higher rates, it emphasizes the Fed's serious gamesmanship aimed at promoting low yields to boost economic growth.

The Fed's ongoing worries about unemployment in particular (and economic strength in general) underline (reflect) its willingness to suppress policy rates. The Chairman notes in his Jackson Hole address: "The unemployment rate remains more than 2 percentage points above what most FOMC participants see as its longer run normal value, and other indicators- such as the labor force participation rate and the number of people working part time for economic reasons- confirm that labor force utilization remains at very low levels. Further, the rate of improvement in the labor market has been painfully slow." And "Over the past five years, the Federal Reserve has acted to support economic growth and foster job creation, and it is important to achieve further progress, particularly in the labor market."

The central bank wants to plant confidence in the hearts and minds of its audiences, so "the Federal Reserve will provide additional policy accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability."

Thus many marketplace prophets confidently foresee a new round of Fed money printing (QE3) soon, or at least "whenever necessary". Note the ECB's September 2012 securities rescue plan, as well as China's announcement of another round of infrastructure spending. The Fed meets September 12-13, October 23-24, and December 11-12, 2012.

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Recall the Fed's need to assess the "economy's long run potential to increase production". What is that potential? This potential is not a scientific probability or fact. Output gaps indicate views on economic slack. The OECD defines an output gap as the difference between actual gross domestic product and potential GDP as a percent of potential GDP. Roughly speaking, a negative output gap implies a slack economy and downward pressure on inflation. If the number is positive, some call this a positive output gap (or an inflationary gap). The positive number indicates that the growth of aggregate demand is outpacing aggregate supply growth, that actual output is more than so-called full capacity output. General references to "the output gap" generally imply the negative output gap (slack economy).

The International Monetary Fund (World Economic Outlook Database, April 2012 contains output gap history and predictions. The United States essentially had no output gap in 2007 (a slightly positive gap of about .1 percent of potential GDP). An output gap (negative gap) of 2.2pc appeared in 2008, expanding to seven pc in 2009. The output gap (still a negative one) was 5.1pc in 2010, and also 5.1pc in 2011. It slumped only slightly to 4.9pc in 2012. The IMF forecasts for America's output gaps: a 4.4pc in 2013, 3.5pc in 2014, 2.4pc in 2015, 1.1pc in 2016, disappearing in 2017. Perhaps the IMF would adjust these slightly given developments since springtime. The Fed's viewpoints probably do not differ greatly from the IMF's. Recall the Fed's "at least through late 2014" comments regarding the duration of the exceptionally low Federal Funds rate in the context of these output gap levels and trends.

Perspectives on the output gap intertwine with analysis of and opinions regarding appropriate employment and unemployment levels. Sustained high unemployment levels may reflect a large output gap, if the economy's productive potential remains as substantial as most economic wizards believe. However, sustained high unemployment in the face of determined longstanding Federal Reserve easing (and political deficit spending) argues that the output gap (long run

productive potential) is significantly less than the IMF and Federal Reserve contend. Suppose the output gap is less than the widespread faith. Then allegedly "normal" (long run) unemployment may be greater than the Fed asserts.

So suppose unemployment unfortunately will tend to remain historically high (above current theories regarding "normal" levels) in part due to the reduction in productive potential (GDP). If so, the Fed's well-intentioned highly accommodative policies eventually run a noteworthy risk of helping greater than desirable inflation to blossom, even if this takes an extended time to develop.

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Current high unemployment levels, as well as trends in some employment measures going back to calendar 2000 (and thus preceding the economic disaster that emerged in 2007), suggest that "normal" unemployment levels probably are quite a bit higher than the Fed and many others believe. If so, America's productive potential and its output gap also probably are less than the Fed argues.

The official unemployment rate (seasonally adjusted; U-3; Bureau of Labor Statistics) rose from 4.4 percent in May 2007 to ten percent in October 2009. That October 2009 level rivaled November 1982's 10.8pc, the summit going back to 1948, early in the post World War Two era. This headline rate was 8.1pc in August 2012, still high by historical standards. Compare the unemployment levels of May 2007 and October 2009 (and currently) with the 2000 unemployment low of 3.9pc (September-December and the June 2003 high of 6.3pc.
The National Bureau of Economic Research puts business cycles troughs in November 2001 (S+P 500 bottom 10/10/02 at 769, final low 3/12/03 at 789) and June 2009 (S+P 500 low 3/6/09 at 667). The official unemployment rate excludes those who have stopped looking for work.

Now survey the U-6, a broader BLS measure of unemployment ("labor underutilization"). This includes "Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force". In August 2012, U-6 unemployment (Table A-15) was 14.7pc, down only modestly from its 17.2pc peak in October 2009. That autumn 2009 height towers over the 7.9pc of December 2006 during the Goldilocks Era. Compare current and October 2009 levels with the much lower 10.4pc high in September 2003 (this rose from 6.8pc in October 2000). Thus as for the official unemployment number, this statistic is both lofty and significantly exceeds the 2003 levels.

U-6 data extend only back to 1994. Its high is January 1994's 11.8pc. The June 1992 official high was 7.8pc, up 1.2pc from the January 1994 level of 6.6pc. Thus U-6's peak back in 1992 was probably over its January 1994 high and perhaps around 13.0 percent. Current U-6 elevations are above this.

Dig into some other key employment statistics (from the BLS; Labor Force Statistics from the Current Population Survey). Again look further backward in time than the dawn of the economic crisis in 2007. Like the official and U-6 unemployment data, both the employment-population ratio and the civilian labor force participation rate suggest that there has been a secular decline in America's "employability potential" and productive capacity.

What does the employment-population ratio history reveal? From a range of around 55.0 to 58.0 percent from 1948 to 1976, it rose from 55.8 pc in June 1975 to 60.1pc in December 1979. After falling to 57.1pc in 1983 (NBER gives the business cycle trough in November 1982), it steadily climbed to its pinnacle of 64.7pc in April 2000. The S+P 500 plateau was 1553 on 3/24/00. The

ratio eroded to 62.0pc in September 2003, a few months after the final S+P 500 bottom at 789 on 3/12/03. During the Goldilocks Era, it recovered, but only to a high of 63.4pc in December 2006. This was beneath its April 2000 high. The employment-population ratio slid under 62.0pc in September 2008 as the worldwide economic crisis accelerated (S+P 500 pinnacle 10/11/07 1577, final peak 5/19/08 at 1440, with a fall off its cliff edge of 9/19/08 at 1265). The ratio reached its depth of 58.2pc in December 2009, well underneath September 2003's 62.0pc. Moreover, for nearly three years it has languished around there, edging only to as high as 58.7pc, with August 2012 at 58.3pc. It thus hovers around the top of the 1948-1976 range.

America's civilian labor force participation rate also shows a declining trend over the past dozen years or so. From about 58.0 percent to 60.5pc from 1948-1972/73, this rate began to rise. It ranged from 66.9.pc in September 1996 to 67.3pc in January-April 2000. It has shown a steady decline since April 2000. It not only retreated under 66.0pc in November 2008 as the international financial crisis worsened, but also has continued to descend during the economic recovery. August 2012's 63.5pc is the lowest in over thirty years (since September 1981).

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Some skeptics may wonder if the Fed's ongoing determined lax policy represents its contribution to a quest to abolish recessions from the globe. What if unemployment remains high or marches higher, whether in the United States, Europe, China, or other key regions? How worried should politicians and regulators be regarding significant social unrest if that occurs?

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